Tpoint Tech

WHAT IS P/E IN SHARE MARKET?

Understanding the Price-to-Earnings Ratio

Prepared by

Racht Joshi

1. Introduction to P/E Ratio

P/E stands for Price-to-Earnings ratio. It is a commonly used financial ratio that compares a company's current market price per share with its earnings per share (EPS). It can help describe how much the market is valuing a company's earnings.

The P/E ratio is one of several measures used when studying a company. It should not be considered on its own because share prices and valuations can be influenced by many factors.

2. P/E Ratio Formula

The basic formula is:

P/E Ratio = Market Price per Share ÷ Earnings per Share (EPS)

For example, if a company's share price is ₹200 and its EPS is ₹20:

P/E = ₹200 ÷ ₹20 = 10

This means the market price is 10 times the company's earnings per share.

3. What Does a P/E Ratio Tell Us?

A P/E ratio provides a way to compare a company's market valuation with its earnings. A higher P/E can indicate that investors are willing to pay more for each unit of current earnings, potentially because they expect future growth or have other positive expectations.

A lower P/E can indicate a lower valuation relative to current earnings, but it does not automatically mean that a share is undervalued. A lower ratio may also reflect slower growth expectations, industry conditions, or business risks.

4. High P/E Ratio

A high P/E ratio means that the market price is relatively high compared with the company's current earnings.

- It may reflect expectations of future earnings growth.
- It may occur in industries where investors expect strong expansion.
- It can also indicate that a stock's valuation is relatively high compared with its current earnings.

A high P/E should therefore be interpreted alongside earnings growth, industry conditions, profitability, and other financial measures.

5. Low P/E Ratio

A low P/E ratio means that the market price is relatively low compared with current earnings.

- It may reflect lower growth expectations.
- It can occur when a company or industry faces uncertainty or challenges.
- It may sometimes indicate a relatively lower valuation, but the ratio alone cannot establish that a stock is undervalued.

6. Types of P/E Ratio

Two commonly discussed approaches are trailing P/E and forward P/E.

- Trailing P/E: Uses earnings from a completed historical period, commonly the previous twelve months.
- Forward P/E: Uses estimated future earnings. Because it relies on forecasts, the value can change when earnings expectations change.

7. P/E Ratio and Industry Comparison

P/E ratios are often more meaningful when compared with companies operating in similar industries. Different industries can naturally have different valuation levels because growth rates, business models, capital requirements, and risks differ.

For example, comparing the P/E of a technology company with that of a mature utility company without considering their different business characteristics may lead to misleading conclusions.

8. P/E Ratio and EPS

Earnings per share (EPS) represents the portion of a company's profit attributable to each outstanding share. Since P/E is calculated using EPS, changes in earnings can directly affect the ratio.

For example, if the market price remains ₹200 but EPS increases from ₹20 to ₹25, the P/E changes from 10 to 8.

9. Limitations of the P/E Ratio

- P/E does not provide a complete picture of a company's financial health.
- Companies with very low or negative earnings may not have a meaningful conventional P/E.
- Different accounting methods can affect reported earnings.
- The ratio does not directly show a company's debt level or cash position.
- Future-growth expectations can have a major effect on market prices.
- Comparisons should consider industry, business model, growth, and risk.

10. Other Ratios to Consider

Investors and analysts commonly examine P/E alongside other measures rather than relying on a single ratio.

- Price-to-Book (P/B) Ratio
- Price-to-Sales (P/S) Ratio
- Debt-to-Equity (D/E) Ratio
- Return on Equity (ROE)
- Earnings per Share (EPS)
- Dividend Yield

11. Conclusion

The P/E ratio is a widely used financial metric that compares a company's share price with its earnings per share. It can provide useful information about how the market values a company's current earnings, but it should be interpreted carefully and in context.

Understanding P/E along with EPS, industry comparisons, growth expectations, financial performance, and other valuation measures provides a more complete picture. This document is intended for educational purposes and is not a recommendation to buy or sell any security.